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SoundInsight N°10

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Surprisingly hawkish wording at the last Fed policy meeting

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Policymakers say economic soft-landing more likely

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Negative reactions across all asset classes

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Energy sector looks structurally and fundamentally attractive

Higher for longer – interest rate pivot postponed

In the Federal Reserve's outlook, the prediction of a "soft landing" for the economy is gaining traction. However, Chair Jerome Powell is in denial about the Fed's soft-landing forecast.

Despite a wide range of challenges, the US economy remains resilient. Thus far, significant interest rate hikes, the collapse of the Silicon Valley Bank, as well as the deadlock over the US government's debt ceiling have left minimal marks on economic growth.

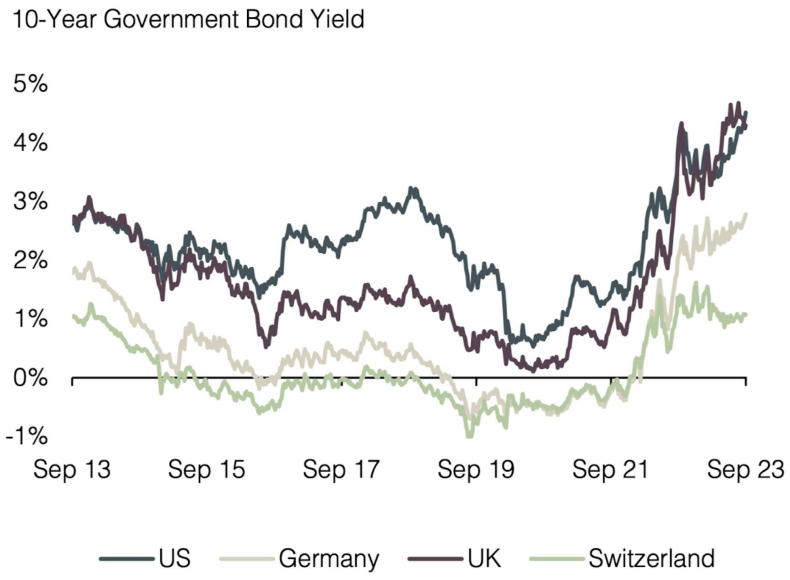
Indeed, Federal Reserve officials are increasingly confident in their ability to curb inflation without provoking a recession or a rise in unemployment. We view this as a trend-following assessment, as the Fed's own forecast was notably more cautious just three months ago. In their recently released quarterly outlook, the Federal Reserve raised its growth projections for 2024 from 1.1% to 1.5%, lowered the expected unemployment rate for 2024 from 4.5% to 4.1%, while sticking to an unchanged inflation expectation of 2.5%. In other words, despite raising interest rates even higher, policymakers now anticipate better economic growth and almost unchanged employment levels. To us, this is a contradictory scenario, especially considering historical patterns and significantly higher levels of debt across the economy.

The improved forecasts are also reflected in the dataset that was highlighted during the press conference. In a nutshell, data is signaling "higher interest rates for an extended period." The "Dot-Plot," which reflects the interest rate expectations of committee members, indicates a 2024 interest rate level of 5.1%, representing a 0.5% increase compared to the last predictions made in June. Contrary to the current market expectations, policymakers anticipate another interest rate hike this year, which would raise the benchmark rate to 5.75%. Despite this very optimistic scenario being outlined in the latest economic forecasts by policymakers, Jerome Powell clearly expressed his reservations when asked by a journalist. He refrained from committing to the statement that he expects a "soft landing" for the US economy.

It appears that central bankers have few alternatives but to consistently maintain high interest rates to avoid triggering another wave of inflation through premature easing. Therefore, the adverse economic effects of higher interest rates are likely to have a more pronounced impact with a time lag. The latest adjustment to the Fed's forecasts has taken market participants by surprise, as the timing for the expected interest rate pivot has been pushed further into the future. Particularly noteworthy is the change in the expected interest rate level. Just six months ago, the market expected interest rates to drop to 3% by the end of 2024. Following the

latest Fed meeting, it is now expected that interest rates start declining by mid-2024 but are unlikely to fall below 4%. Both bond and equity markets reacted negatively to the more restrictive monetary policy outlook.

We continue to view the current interest rate levels as attractive, especially considering that some central banks, including the Swiss National Bank, consider the interest rate tightening cycle to be completed. Regarding credit spreads, we remain cautious. In the equity space, decreasing leading indicators and a low-risk premium continue to suggest an underweighting. Due to significant relative valuation disparities, we find the energy sector attractive, driven by both fundamentals and structural factors. In the realm of alternative investments, gold remains remarkably stable despite higher interest rates and a stronger US dollar. An allocation to gold provides a good diversification opportunity in the current market environment.

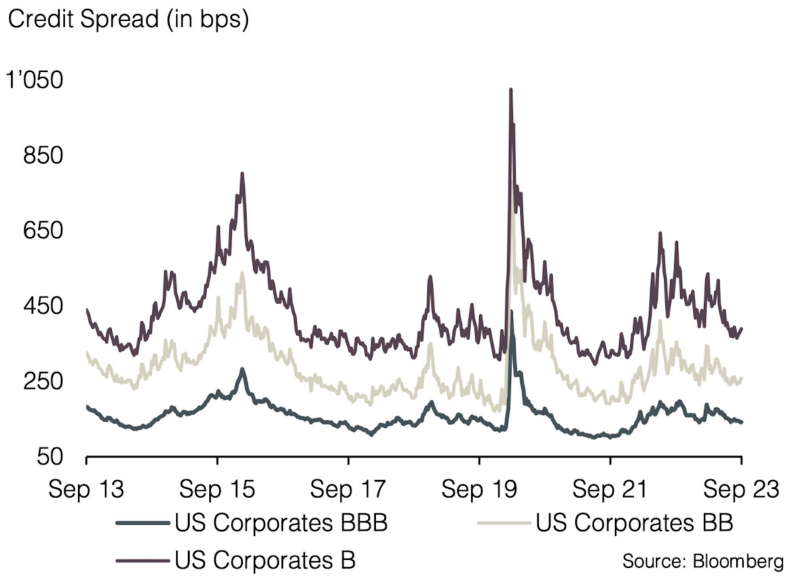


Yields

2-year US Treasury yields are close to reaching their highest level since the 2000s. The interest rate environment in the US is currently as attractive as it has been in a long time, which, from our perspective, argues in favor of extending maturities. Due to the persistently high core inflation in Germany, market participants appear divided regarding the next action of the European Central Bank. Although the market does not anticipate further interest rate hikes, a data- driven ECB has not shown any signs of ending the era of higher interest rates. However, it is reasonable to assume that, if at all, only few more interest rate hikes are on the horizon.



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Spreads

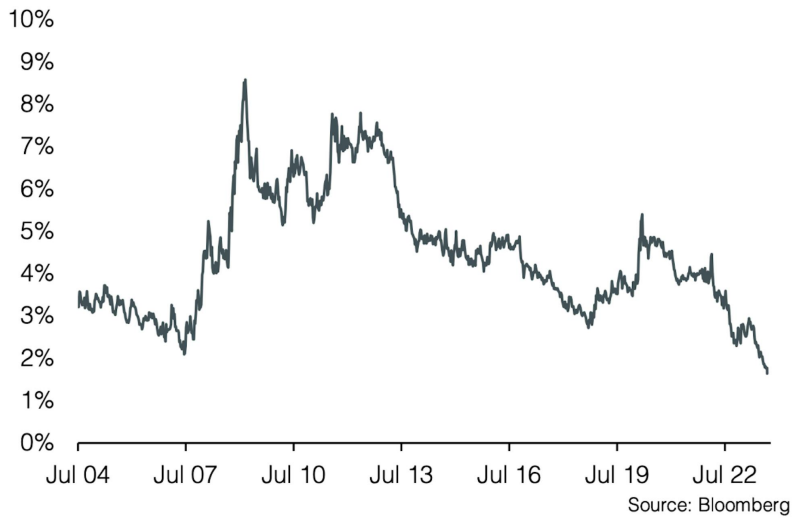
The market's response to rising interest rates confirms our cautious stance regarding credit spreads. Especially in the high-yield bond space, there were significant losses following the FED press conference. The longer interest rates remain at this level, the more highly leveraged companies will be forced to refinance at comparatively high costs. Given that credit spreads in the current market environment remain at exceptionally low levels, we continue to favor high quality bonds.



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US Shiller Equity Risk Premium



Source: Bloomberg

Equity Risk Premium

The equity risk premium remains unattractive, with rising interest rates further contributing to a lower level. However, due to the substantial weight of the technology sector, the US market also appears disproportionately expensive. Upon closer examination, it is evident that certain areas of the stock market, such as the energy sector, are attractively valued.



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Leading Indicators

The gap between the performance of the services sector and manufacturing is gradually narrowing. While manufacturing has stabilized at a low level, the services sector, especially in Europe, is showing signs of contraction. In general, leading indicators have deteriorated slightly but remain within the neutral range.



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Manufacturing PMI

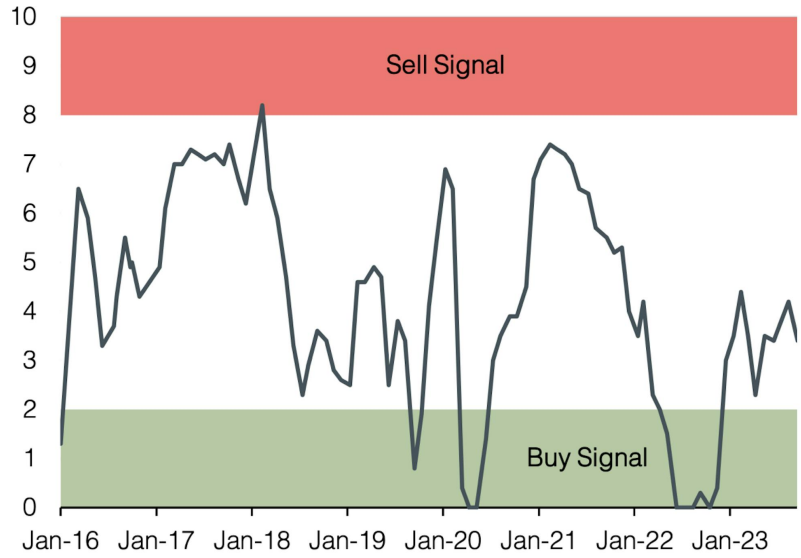
	Dec 21	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23	Aug 23	Sep 23
Global	54.3	53.2	53.7	53.0	52.3	52.4	52.2	51.1	50.3	49.8	49.4	48.8	48.7	49.1	49.9	49.6	49.6	49.5	48.7	48.6	49.0	
USA ISM	58.6	57.6	58.4	57.0	55.9	56.1	53.1	52.7	52.9	51.0	50.0	49.0	48.4	47.4	47.7	46.3	47.1	46.9	46.0	46.4	47.6	
Europe	58.0	58.7	58.2	56.5	55.5	54.6	52.1	49.8	49.6	48.4	46.4	47.1	47.8	48.8	48.5	47.3	45.8	44.8	43.4	42.7	43.5	43.4
United Kingdom	57.9	57.3	58.0	55.2	55.8	54.6	52.8	52.1	47.3	48.4	46.2	46.5	45.3	47.0	49.3	47.9	47.8	47.1	46.5	45.3	43.0	44.2
Switzerland	64.5	63.7	62.7	63.3	61.6	59.8	59.1	58.0	56.7	56.8	55.4	54.4	54.5	49.3	48.9	47.0	45.3	43.2	44.9	38.5	39.9	
China Local	50.3	50.1	50.2	49.5	47.4	49.6	50.2	49.0	49.4	50.1	49.2	48.0	47.0	50.1	52.6	51.9	49.2	48.8	49.0	49.3	49.7	
Japan	54.3	55.4	52.7	54.1	53.5	53.3	52.7	52.1	51.5	50.8	50.7	49.0	48.9	48.9	47.7	49.2	49.5	50.6	49.8	49.6	49.6	48.6

Services PMI

	Dec 21	Jan 22	Feb 22	Mar 22	Apr 22	May 22	Jun 22	Jul 22	Aug 22	Sep 22	Oct 22	Nov 22	Dec 22	Jan 23	Feb 23	Mar 23	Apr 23	May 23	Jun 23	Jul 23	Aug 23	Sep 23
Global	54.7	51.0	54.0	53.4	52.2	51.9	53.8	51.1	49.3	50.0	49.2	48.1	48.0	50.1	52.6	54.4	55.4	55.5	53.9	52.7	51.1	
USA ISM	61.7	60.4	57.2	58.4	57.5	56.4	56.0	56.4	56.1	55.9	54.5	55.5	49.2	55.2	55.1	51.2	51.9	50.3	53.9	52.7	54.5	
Eurozone	53.1	51.1	55.5	55.6	57.7	56.1	53.0	51.2	49.8	48.8	48.6	48.5	49.8	50.8	52.7	55.0	56.2	55.1	52.0	50.9	47.9	48.4
United Kingdom	53.6	54.1	60.5	62.6	58.9	53.4	54.3	52.6	50.9	50.0	48.8	48.8	49.9	48.7	53.5	52.9	55.9	55.2	53.7	51.5	49.5	47.2
Switzerland	59.9	56.4	64.3	61.1	56.2	59.6	58.1	55.6	56.6	52.8	53.8	53.4	49.5	56.7	55.3	54.2	52.2	52.6	49.6	42.7	50.3	
China Local	52.0	50.3	50.5	46.7	40.0	47.1	54.3	52.8	51.9	48.9	47.0	45.1	39.4	54.0	55.6	56.9	55.1	53.8	52.8	51.5	50.5	
Japan	52.1	47.6	44.2	49.4	50.7	52.6	54.0	50.3	49.5	52.2	53.2	50.3	51.1	52.3	54.0	55.0	55.4	55.9	54.0	53.8	54.3	53.3

Description: The Purchasing Managers' Index (PMI) is a forward-looking economic indicator based on company surveys. A value above 50 indicates an improving economic environment, whereas a value below 50 indicates a worsening environment.

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Risk-Index

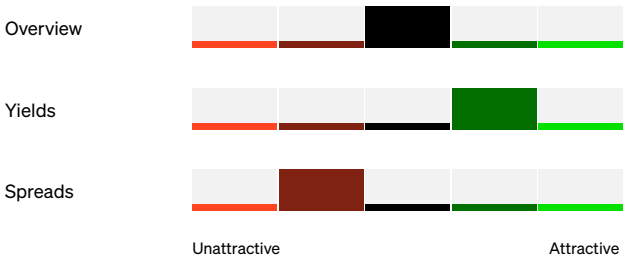
Strong inflows into money market funds and government bonds indicate a less positive sentiment. However, the overall index remains in the neutral range.



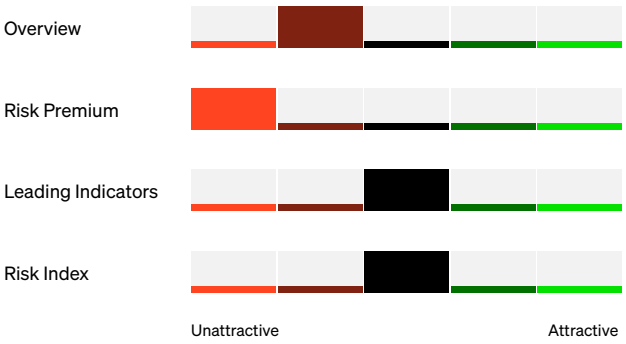
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Bonds



Equities



Appendix

Sound Invest is the central tool for our investment allocation. We use it to systematically and consistently assess the aspects that are relevant to the development of the financial markets. As a result, our clients can rely on a rational and anti-cyclical implementation of our investment decisions.

- **Focusing on the essentials** Interest rate level, risk premium, valuation, economic development, investor sentiment and positioning. These are the decisive factors for success on the financial markets, especially in turbulent times when the temptation to react irrationally to the headlines is particularly strong.
- **Comparability over time and place**
  The factors mentioned above are equally relevant for all markets and at all times. This is the result of a strict «backtesting» process that continues into the future.
- **Cumulating our investment experience**
  Our strength lies in the many years of experience of our partners and principals. It is precisely this experience that we summarize and make it applicable with Sound Invest.
- **Transparency**
  Thanks to our monthly publication, our clients always know where we stand in the investment cycle and how we expect the financial markets to develop.

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Datasource: Bloomberg, BofA ML Research